

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

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In the Matter of  
Petition of AT&T Communications  
of Virginia, Inc., Pursuant  
to Section 252(e)(5) of the  
Communications Act, for Preemption      CC Docket No. 00-251  
of the Jurisdiction of the Virginia  
State Cooperation Commission  
Regarding Interconnection Disputes  
with Verizon-Virginia, Inc.

In the Matter of  
Petition of WorldCom, Inc. Pursuant  
to Section 252(e)(5) of the  
Communications Act for Expedited  
Preemption of the Jurisdiction of the      CC Docket No. 00-218  
Virginia State Corporation Commission  
Regarding Interconnection Disputes  
with Verizon-Virginia, Inc., and for  
Expedited Arbitration

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**SURREBUTTAL TESTIMONY OF JOHN I. HIRSHLEIFER**

**ON BEHALF OF**

**AT&T AND WORLDCOM, INC.**

September 21, 2001

## TABLE OF CONTENTS

<b>I.</b>	<b>DR. VANDER WEIDE'S ESTIMATE OF THE COST OF EQUITY IS SYSTEMATICALLY BIASED UPWARD. ....</b>	<b>2</b>
A.	DR. VANDER WEIDE'S ASSUMPTION OF PERPETUAL GROWTH GUARANTEES AN EXCESSIVE RATE OF RETURN. ....	2
B.	THE RISKS OF SUPPLYING UNBUNDLED NETWORK ELEMENTS IN VIRGINIA DO NOT JUSTIFY THE USE OF DCF COMPARISON GROUPS THAT INCLUDE NON-TELEPHONE COMPANIES. ....	17
	1. <i>TELRIC cost principles do not require the Commission to assume that Verizon Virginia faces intense competition regardless of the facts.</i> .....	17
	2. <i>Dr. Vander Weide exaggerates the competitive risk of VZ-VA's local telephone service generally and fails to distinguish between the competitive risks of providing UNEs at wholesale and providing local telephone services at retail.</i> .....	24
	3. <i>Dr. Vander Weide has not offered plausible or consistent reasons why telephone companies should not form the appropriate DCF comparison group.</i> .....	29
C.	THE S&P INDUSTRIAL COMPANIES SELECTED BY DR. VANDER WEIDE ARE NOT A VALID COMPARISON GROUP FOR A DCF ANALYSIS OF THE COST OF EQUITY OF THE NETWORK ELEMENT BUSINESS. ....	35
D.	DR. VANDER WEIDE'S MISCELLANEOUS CRITICISMS OF MY DCF ANALYSIS OF EQUITY COSTS ARE WITHOUT MERIT .....	36
E.	DR. VANDER WEIDE'S CRITICISMS OF MY CAPM ANALYSIS OF EQUITY COSTS ARE ALSO UNFOUNDED .....	38
<b>II.</b>	<b>DR. VANDER WEIDE HAS ASSUMED A CAPITAL STRUCTURE THAT IS INAPPROPRIATE FOR THE WHOLESALE BUSINESS OF SUPPLYING UNBUNDLED NETWORK ELEMENTS.....</b>	<b>53</b>
<b>III.</b>	<b>DR. VANDER WEIDE'S COST OF CAPITAL ESTIMATES ARE GROSSLY AT ODDS WITH ANALYSES BY INVESTMENT FIRMS AND OTHER INDEPENDENT ANALYSTS. ....</b>	<b>60</b>
<b>IV.</b>	<b>DR. VANDER WEIDE'S CONTRIVED "TESTS OF REASONABLENESS" UNDERScore THE REASONABLENESS OF MY COST OF CAPITAL ESTIMATES, NOT HIS.....</b>	<b>75</b>

***Surrebuttal Testimony of John I. Hirshleifer***

1   **Q.   PLEASE STATE YOUR FULL NAME AND OCCUPATION.**

2   A.   My name is John I. Hirshleifer and my business address is Charles River Associates, Inc.,  
3       10877 Wilshire Blvd., Los Angeles, California 90024. I am a Vice President at Charles  
4       River Associates, Inc. (CRA), an international financial and economic consulting firm.

5   **Q.   ARE YOU THE SAME JOHN HIRSHLEIFER WHO PREVIOUSLY**  
6       **SUBMITTED PREPARED DIRECT (7/31/01) AND REBUTTAL (8/17/01)**  
7       **TESTIMONIES ON BEHALF OF AT&T AND WORLDCOM IN THIS**  
8       **PROCEEDING?**

9   A.   Yes, I am.

10  **Q.   WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

11  A.   The purpose of my surrebuttal testimony is to respond to the prepared rebuttal testimony  
12       dated August 27, 2001 submitted in this proceeding by Dr. James H. Vander Weide  
13       ("Vander Weide Rebuttal") on behalf of Verizon Virginia ("VZ-VA") regarding the cost  
14       of capital.<sup>1</sup> In Sections I and II, I address Dr. Vander Weide's criticisms with respect to  
15       my cost of equity and capital structure estimates. In Section III, I refute Dr. Vander  
16       Weide's attempts to discard the cost of capital estimates used by investment banks and  
17       industry analysts. In Section IV, I rebut Dr. Vander Weide's "Tests of Reasonableness".  
18  
19

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<sup>1</sup> I also respond to cost of capital issues discussed by Drs. Jerry A. Hausman and Howard Shelanski in their prepared rebuttal testimonies dated August 27, 2001.

*Surrebuttal Testimony of John I. Hirshleifer*

**I. DR. VANDER WEIDE'S ESTIMATE OF THE COST OF EQUITY IS SYSTEMATICALLY BIASED UPWARD.**

**A. Dr. Vander Weide's Assumption Of Perpetual Growth Guarantees An Excessive Rate Of Return.**

**Q. IN HIS REBUTTAL TESTIMONY DR. VANDER WEIDE ATTEMPTS TO BOLSTER HIS INCORRECT USE OF THE SINGLE STAGE DCF MODEL. (VANDER WEIDE REBUTTAL, PP. 43-46) IS HE ABLE TO CITE ANY LEADING AUTHORITY SUPPORTING THE USE OF THE SINGLE STAGE MODEL WHEN THE GROWTH RATE SIGNIFICANTLY EXCEEDS THE GROWTH RATE OF THE ECONOMY?**

**A.** No. While I cite numerous leading scholars and practitioners in my direct testimony that clearly explain why the single-stage model is inappropriate for use in those circumstances, it is striking that he can cite nothing that rebuts these authorities. Obviously, these experts would not be advocating the superiority of multiple stage models if any of Dr. Vander Weide's arguments offered in regulatory proceedings regarding the single stage DCF model were true.

**Q. DR. VANDER WEIDE'S ONE-STAGE DCF MODEL ASSUMES THAT ALL COMPANIES IN THE S&P INDUSTRIALS, INCLUDING ALL TELEPHONE HOLDING COMPANIES, WILL GROW FOREVER AT RATES HIGHER THAN THE GROWTH RATE OF THE ECONOMY. IN SUPPORT OF HIS MODEL DR. VANDER WEIDE ARGUES THAT "IT IS COMMON FOR COMPANIES TO GROW AT RATES SIGNIFICANTLY GREATER THAN THE RATE OF GROWTH IN GNP FOR LONG PERIODS OF TIME." (VANDER WEIDE**

*Surrebuttal Testimony of John I. Hirshleifer*

1        **REBUTTAL, P. 44) IN PRIOR TESTIMONIES HE HAS CITED CERTAIN**  
2        **COMPANIES, SUCH AS WAL-MART, INTEL, MERCK AND CENTURYTEL,**  
3        **AS EXAMPLES THAT HAVE GROWN AT HIGH RATES FOR LONGER THAN**  
4        **FIVE YEARS.<sup>2</sup> IS HIS REASONING CORRECT?**

5        A.     No. No company, not even Wal-Mart, Intel, Merck and CenturyTel, will grow at those  
6        rates perpetually. Studios analysts would be hard-pressed to agree that these particular  
7        companies will all grow at high rates for the *next* 20 years, let alone forever. Intel, for  
8        example, has been the single most dominant microprocessor producer serving the  
9        microcomputer industry, which grew from a base of close to zero in the early 1980s,  
10       when microcomputers were unknown to consumers, to widespread use worldwide as of  
11       today. Obviously, the entire S&P Industrials does not enjoy the incredible position that  
12       Intel was in at the commencement of the 1980s.

13                Indeed, Intel's stock price dropped 70% from September 1, 2000 until September  
14                19, 2001, and the company has reduced prices on its premier microchips.

15                It may be too early to know whether Intel's projected decline in earnings is a  
16                short-term blip or the harbinger of a longer-term slowdown in growth. One fact is clear,  
17                however: Intel is unlikely to continue growing indefinitely at the pace it set in recent  
18                years as its markets continue to saturate.

19        **Q.     IN SELECTING A FEW COMPANIES THAT HAVE HAD SEVERAL YEARS**  
20        **OF HIGH GROWTH, DID DR. VANDER WEIDE MENTION THE COMPANIES**  
21        **THAT HAD AVERAGE, OR POOR, OR NEGATIVE GROWTH?**

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<sup>2</sup> See e.g., Rebuttal Testimony of Dr. Vander Weide on behalf of Verizon-New England, Case DTE 01-20 (Part A), filed July 18, 2001, p. 56.

***Surrebuttal Testimony of John I. Hirshleifer***

1     A.     No. And Dr. Vander Weide is unable to tell us which companies of his S&P Industrial  
2           sample, or even of a sample of telephone companies, will grow at above-average rates,  
3           and which will have average or below-average rates of growth. Just in the last three years  
4           Laidlaw, Helmerich & Payne, Forster Wheeler, Fleetwood Enterprises, Pep Boys, Silicon  
5           Graphics, IKON Office Solutions, Milacron and several others were dropped from the  
6           S&P Industrial group. Laidlaw's earnings growth rate averaged *negative* 1% over a 10-  
7           year period; Pep Boys' *negative* 8.5% over the past 5 years; IKON's *negative* 7.0% over  
8           the past 10 years and *negative* 18.0% over the past 5 years.<sup>3</sup> Had these and other  
9           companies that were dropped from the S&P Industrials over the course of time in fact  
10          remained in the set, the expected growth rate for the aggregate sample would also likely  
11          be lower than the rate currently forecasted.

12    **Q.     IS THE S&P 500 GENERALLY DESIGNED TO BE AN INDEX OF LEADING**  
13          **COMPANIES?**

14    A.     Yes. The guiding principle for inclusion in the S&P 500 is that they are "leading  
15          companies in leading US industries."<sup>4</sup> In addition to rebutting Dr. Vander Weide's  
16          argument that all companies are expected to grow at high rates forever, this fact  
17          highlights a selection bias that further taints his choice of comparables. By using an  
18          index that is periodically repopulated by dropping selected poorly-performing companies  
19          and adding better-performing companies, Dr. Vander Weide is assuring himself that he

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<sup>3</sup> Value Line Investment Survey, Stock Profile Reports, May 18, 2001, and April 20, 2001.

<sup>4</sup> Standard & Poor's, General Criteria for S&P U.S. Index Membership, September 2000, p. 3.

## *Surrebuttal Testimony of John I. Hirshleifer*

1 will be using companies expected to have comparatively favorable growth expectations  
2 on the whole.

3 **Q. DO OTHER SCHOLARS AND PRACTITIONERS AGREE THAT COMPANIES**  
4 **OFTEN FAIL TO SUSTAIN ABOVE-AVERAGE RATES OF EARNINGS**  
5 **GROWTH?**

6 A. Yes. They are well aware of the fact that not all of the companies that have grown for  
7 many years at high growth rates will necessarily continue to exhibit such rapid growth.

8 Burton Malkiel, for example, has stated that,

9 Corporations and industries have life cycles similar to most living  
10 things. There is, for corporations in particular, a high mortality rate  
11 at birth. *Survivors* can look forward to rapid growth, maturity, and  
12 then a period of stability. Later in the life cycle, companies  
13 eventually decline and either perish or undergo a substantial  
14 metamorphosis. Consider the leading corporations in the United  
15 States 100 years ago. *Such names as Eastern Buggy Whip Company,*  
16 *La Crosse and Minnesota Steam Packet Company, Lobdell Car*  
17 *Wheel Company, Savanna and St. Paul Steamship Line, and Hazard*  
18 *Power Company, the already mature enterprises of the time, would*  
19 *have ranked high in a "Fortune Top 500" list of that era. All are*  
20 *now deceased...*

21 *And even if the natural life cycle doesn't get a company, there's*  
22 *always the fact that it gets harder and harder to grow at the same*  
23 *percentage rate. A company earning \$1 million need increase its*  
24 *earnings by only \$100,000 to achieve a 10 percent growth rate,*  
25 *whereas a company starting from a base of \$10 million in earnings*  
26 *needs \$1 million in additional earnings to produce the same record.*

27 *The nonsense of relying on very high long-term growth rates is*  
28 *nicely illustrated by working with population projections for the*  
29 *United States. If the populations of the nation and of California*  
30 *continue to grow at their recent rates, 120 percent of the United*  
31 *States population will live in California by the year 2035! Using*  
32 *similar kinds of projections, it can be estimated that at the same time*

## *Surrebuttal Testimony of John I. Hirshleifer*

1                   240 percent of the people in the country with venereal disease will  
2                   live in California. As one Californian put it on hearing these  
3                   forecasts, 'Only the former projections make the latter one seem at  
4                   all plausible.'<sup>5</sup>

5   **Q.     DR. VANDER WEIDE ARGUES THAT THE SINGLE-STAGE DCF MODEL IS**  
6           **VALID IF FIRMS CAN GROW AT A CONSTANT GROWTH RATE IN EXCESS**  
7           **OF GNP FOR 40 OR 50 YEARS. (VANDER WEIDE REBUTTAL, P. 45) IS THIS**  
8           **A HELPFUL DEFENSE OF THE SINGLE-STAGE MODEL?**

9   A.    No. It appears to be a very strong argument *against* using the single stage model. It is  
10       impossible to predict which, if any, companies could grow at rates above the economy's  
11       growth for that length of time. It does not appear that many would grow at high rates for  
12       that long. While some *small* companies with novel products can have many years of high  
13       percentage growth, most do not.<sup>6</sup> Sustained future periods of above-average growth are  
14       less likely for the average company in the S&P 500 list: a company must already have a  
15       relatively large capitalization to enter the list in the first place. And sustained future  
16       periods of above-average are even less likely for Verizon, the largest telephone holding  
17       company in the United States, and the other Bell holding companies. These are already  
18       enormous companies, and their growth rates are likely to slow further as the high-growth  
19       worldwide markets for wireless phones and data services saturate.

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<sup>5</sup> Burton G. Malkiel, *A Random Walk Down Wall Street*, 1999, pp. 97-99 (emphasis added).

<sup>6</sup> "While many investors recall the story stocks, such as Intel, Microsoft, and Wal-Mart, which have made investors rich, most forget about the many new firms that fail to fulfill their promise when they are issued. A study by Tim Loughran and Jay Ritter followed every operating company (almost 5,000) that went public between 1970 and 1990. Those who bought at the market price on the first day of trading and held the stock for five years, reaped an average annual return of only 5 percent." Jeremy J. Siegel, *Stocks for the Long Run* (1994), at p. 93 (citation omitted).



## *Surrebuttal Testimony of John I. Hirshleifer*

1 Investment bankers, for example, do not assume 40 to 50 years of high growth in  
2 their valuation analyses. All use growth rate projections that assume that growth tapers  
3 off over time in their DCF models. In valuing Sprint PCS, Morgan Stanley Dean Witter  
4 (Morgan Stanley) projected an initially high free cash flow growth rate which  
5 consistently declines every year: 76.9% (2003), 46.1% (2004), 25.3% (2005), 13.7%  
6 (2006), 8.7% (2007) and 4.2% (2008). After 2008, Morgan Stanley specifically stated  
7 that it assumed a 6.0% growth of free cash flow in perpetuity.<sup>7</sup>

8 Similarly, Morgan Stanley projected declining free cash flow growth rates for  
9 Alltel, one of the companies in my sample of comparables: 25.6% (2001), 18.4% (2002),  
10 12.8% (2003), 8.9% (2004), 8.4% (2005), 6.0% (2006), 4.5% (2007) and 1.2% (2008)  
11 and assumed the perpetual growth after year 2008 to be 4%.<sup>8</sup>

12 If Morgan Stanley had assumed 40 years of growth for Alltel at the average  
13 growth rate over the first five years of 14.8%, or even at 8.4% as of year 5, it would have  
14 obtained a much higher valuation.

15 **Q. IN PERFORMING DCF VALUATIONS, HAVE YOU EVER SEEN AN**  
16 **INVESTMENT BANK OR FINANCIAL ANALYST ASSUME THAT A**  
17 **COMPANY'S EARNINGS OR CASH FLOWS WILL GROW AT EITHER A**  
18 **HIGH RATE PERPETUALLY, OR FOR 40 OR 50 YEARS?**

19 A. No. I have examined numerous DCF valuations over the years and all have used forecast  
20 methodologies similar to those used by investment banks as described in the prior

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<sup>7</sup> Morgan Stanley Dean Witter, "Sprint PCS Group," March 13, 2000, p. 6.

<sup>8</sup> Morgan Stanley Dean Witter, "Alltel Corporation," March 13, 2000, p. 3.

*Surrebuttal Testimony of John I. Hirshleifer*

1        answer. This is because analysts are constrained by the reasonability of their valuation  
2        results. No one reasonably expects that companies that are growing quickly now will  
3        grow at high rates for long, long periods of time. If one were to make such assumptions,  
4        the resulting valuations would be stratospheric, and it would be clearly evident to the  
5        analyst that the assumptions made were simply wrong.

6        **Q.    IS IT REASONABLE TO ASSUME THAT THE ENTIRE S&P INDUSTRIALS**  
7        **WILL GROW AT RATES EXCEEDING THE GROWTH RATE OF THE**  
8        **ECONOMY FOR 40 OR 50 YEARS?**

9        A.    No. It is fairly easy to predict that the companies which currently comprise the S&P  
10        Industrials, used by Dr. Vander Weide as his comparable set, will *not* grow at rates  
11        significantly above the economy's growth rate for that length of time.

12       **Q.    IF DR. VANDER WEIDE SAYS THAT ONLY 40 TO 50 YEARS OF HIGH**  
13       **GROWTH ARE REQUIRED TO MAKE THE SINGLE-STAGE MODEL**  
14       **ACCEPTABLE, IS HE REALLY SAYING THAT HE SHOULD BE USING A**  
15       **TWO-STAGE MODEL WITH 40 YEARS OF SUPERNORMAL GROWTH AND**  
16       **THEREAFTER GROWTH AT THE ECONOMY'S RATE?**

17       A.    Of course. He is clearly validating the use of multiple stage models, although he  
18       unrealistically assumes that virtually all companies will grow at high rates for long  
19       periods of time.

20       **Q.    IF HE WERE TO USE A TWO-STAGE DCF MODEL THAT ASSUMED 40**  
21       **YEARS OF SUPERNORMAL GROWTH, WOULD HE ARRIVE AT THE SAME**  
22       **COST OF EQUITY ESTIMATE THAT HE OBTAINS FROM A SINGLE STAGE**  
23       **DCF MODEL?**

### ***Surrebuttal Testimony of John I. Hirshleifer***

1 No. which entirely contradicts his assertion that 40 years of supernormal growth justifies  
2 the use of a single stage model. Even in comparison to a two-stage model with 40 years  
3 of supernormal growth, the one-stage model yields a significantly higher cost of equity.

4 To illustrate, I calculated the costs of equity of a hypothetical company using a  
5 one-stage DCF model and a 2-stage DCF model assuming that the high growth rate lasts  
6 40 years. For this illustration I assumed that the company's IBES-equivalent growth rate  
7 equals the weighted average IBES growth rates of the telephone holding companies in my  
8 comparables sample (12.15%), and that the company pays a dividend yield of 2.53%,  
9 equal to the weighted average dividend yield of the sample. If it were assumed that 40  
10 years of growth were correct, the cost of equity estimated using the one-stage DCF model  
11 overstates the cost of equity calculated using the 40-year two-stage DCF model by at least  
12 150 basis points. (See Attachment JH-1.)

13 Moreover, the present value of the projected dividend stream in year 41 and  
14 beyond composes 41% of the total present value of the stock if the single-stage DCF  
15 model is used. The present value of just the portion of the dividend stream projected for  
16 year 100 and beyond accounts for 11% of the current stock value. Alternatively, using a  
17 modified 3-stage DCF model which assumes the first stage to last 20 years and  
18 convergence to the long-term growth rate of economy over the next 20 years, one arrives  
19 at a cost of equity estimate of 12.38%, 230 basis points lower than the single-stage DCF  
20 estimate.

21 **Q. HAS DR. VANDER WEIDE ALWAYS ARGUED THAT AN ASSUMPTION OF**  
22 **40 TO 50 YEARS OF SUPERNORMAL GROWTH IS ALL THAT IS REQUIRED**  
23 **TO USE THE SINGLE STAGE MODEL?**

***Surrebuttal Testimony of John I. Hirshleifer***

1 A. No. In his testimony in the 1997 Virginia UNE proceeding, his alternative, but similar,  
2 argument was that the impact on present value of dividend growth rate assumptions  
3 beyond *20 years* was de minimis due to the effect of discounting.<sup>9</sup> In fact, the present  
4 value of constantly-growing dividends beyond year 20 accounts for more than 60% of the  
5 company's stock value using my hypothetical company.

6 **Q. WHAT COST OF CAPITAL WOULD RESULT IF A TWO-STAGE DCF MODEL**  
7 **WITH A FIRST STAGE OF 20 YEARS OF SUPERNORMAL GROWTH IS**  
8 **UTILIZED?**

9 A. If I were to calculate a cost of equity assuming 20 years of supernormal growth as Dr.  
10 Vander Weide suggested, and then growth at the economy growth rate, the resulting cost  
11 of equity would equal 11.48%, 320 basis points less than the single-stage DCF estimate.

12 **Q. HAS VERIZON ACKNOWLEDGED IN ANY OTHER CASE THAT THE**  
13 **CHOICE BETWEEN HIS ONE-STAGE DCF MODEL AND YOUR THREE-**  
14 **STAGE MODEL HAS A SIGNIFICANT EFFECT ON THE COST OF CAPITAL?**

15 A. Yes. The cost of capital analysis submitted by Verizon's predecessor NYNEX in the  
16 1996-97 UNE proceeding in Massachusetts illustrates this fact. Dr. Vander Weide was  
17 NYNEX's cost of capital witness in that case; and his methodology—including his one-  
18 stage DCF—was essentially identical to his methodology here.<sup>10</sup> In its initial decision,  
19 the Massachusetts commission adopted Dr. Vander Weide's methodology in its entirety,

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<sup>9</sup> Direct Examination of Dr. James H. Vander Weide, Before the State Corporation Commission of Virginia, On Behalf of Bell-Atlantic-Virginia, Inc., Case No. PUC970005, pp. 204-5.

<sup>10</sup> In the Matter of the Review of Unbundled Network Elements Rates, Terms and Conditions of BA-NJ, NJ BPU Docket No. TO00060356, 1 Tr. (Nov. 28, 2000), pp. 41-45 (Vander Weide).

## *Surrebuttal Testimony of John I. Hirshleifer*

1 with one exception: the commission directed NYNEX to file an alternative cost of capital  
2 calculation that substituted AT&T witness Dr. R. Glenn Hubbard's<sup>11</sup> three-stage DCF  
3 model for Dr. Vander Weide's one-stage model.<sup>12</sup> In response, NYNEX submitted a  
4 calculation showing that this one change would materially reduce the weighted average  
5 cost of capital.<sup>13</sup> When shown this document during cross-examination in the New Jersey  
6 UNE cost proceeding, Dr. Vander Weide acknowledged that the choice between his one-  
7 stage DCF and my three-stage DCF accounted for approximately 200 basis points of the  
8 difference between our cost of capital estimates.<sup>14</sup>

9 **Q. DR. VANDER WEIDE CLAIMS THAT VALUE LINE FORECAST DATA CAN**  
10 **BE USED TO SUPPORT HIS ASSUMPTION THAT THE 5-YEAR I/B/E/S**  
11 **GROWTH RATES FOR HIS GROUP OF "COMPARABLE" COMPANIES WILL**  
12 **PERSIST INDEFINITELY IN THE FUTURE (VANDER WEIDE REBUTTAL P.**  
13 **46). HOW DO YOU RESPOND TO THIS ASSERTION?**

14 A. I first note that in prior rebuttal testimonies, Dr. Vander Weide has claimed that Value  
15 Line itself "publishes an estimate of each company's long-run growth from internal  
16 sources beyond the period beginning in 2003-2005"<sup>15</sup> which according to him confirmed

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<sup>11</sup> Dr. Hubbard is currently Chairman of the President's Council of Economic Advisors.

<sup>12</sup> *Id.*, pp. 47-50 (Vander Weide); D.P.U. 96-73/74, 96-75, 96-80/81, 96-83, 96-94 – Phase 4, *Consolidated Petitions of New England Telephone and Telegraph Company d/b/a NYNEX, Teleport Communications Group, Inc., Brooks Fiber Communications, AT&T Communications of New England, Inc., MCI Communications Company, and Sprint Communications Company, L.P., pursuant to Section 252(b) of the Telecommunications Act of 1996, for arbitration of interconnection agreements between NYNEX and the aforementioned companies* (released Dec. 4, 1996) ("Phase 4 Decision")

<sup>13</sup> Letter dated December 18, 1996 from Bruce Beausejour, NYNEX counsel, to Mary L. Cottrell, Secretary to MDTE.

<sup>14</sup> NJ BPU Docket No. *No.* TO00060356, *supra*, 1 Tr. (Nov. 28, 2000), pp. 50-51 (Vander Weide).

<sup>15</sup> *See e.g.*, Responsive Testimony of Dr. Vander Weide on behalf of Bell Atlantic-New York, Case 98-C-1357, filed June 26, 2000, p. 41.

## ***Surrebuttal Testimony of John I. Hirshleifer***

1 that relatively high growth rates could be sustained for indefinitely long periods. This  
2 assertion foundered because it was clear to any reader of the Value Line reports that  
3 forecasts are provided for up to 5 years only. In fact, the Value Line reports cited by Dr.  
4 Vander Weide provided no forecast beyond the year 2005. My staff additionally  
5 confirmed directly with Value Line that it does not make such long-term forecasts  
6 asserted then by Dr. Vander Weide.

7 **Q. IF VALUE LINE DOES NOT MAKE FORECASTS BEYOND A FIVE-YEAR**  
8 **HORIZON, HOW IS DR. VANDER WEIDE UTILIZING DATA OBTAINED**  
9 **FROM VALUE LINE?**

10 Dr. Vander Weide is saying that, by using the traditional book “b X r” method (where “b”  
11 represents book earnings that are retained by the company, and “r” represents the book  
12 return on *book* equity), he, not Value Line, is inferring a long-run growth rate by looking  
13 at *book* retained earnings growth and *assuming* it will persist indefinitely into the future.

14 Dr. Vander Weide is simply taking data from Value Line reports and using a  
15 method sometimes used in past traditional regulatory hearings for stable, regulated  
16 industries which are not expected to experience significant variance from their historical  
17 growth rates, and whose book value equities are approximately equal to the market value  
18 of their equities. Similar to his assertions that 5-year analyst forecast growth rates are  
19 expected by investors to persist forever, Dr. Vander Weide has not provided any evidence  
20 that investors believe that supernormal growth rates obtained using this alternative  
21 method will persist forever.

22 **Q. IS THE USE OF A METHOD WHICH IS BASED ON THE RETURN ON BOOK**  
23 **EQUITY CONSISTENT WITH DR. VANDER WEIDE’S TESTIMONY**

***Surrebuttal Testimony of John I. Hirshleifer***

**REGARDING THE APPROPRIATE CAPITAL STRUCTURE TO BE USED IN  
ESTIMATING THE COST OF CAPITAL?**

A. No. Dr. Vander Weide has vociferously argued that a market-value capital structure is the only one that can be used because a book capital structure is based on embedded costs and is backward looking. Consequently, his argument that a book value method is appropriate for estimating growth, a critical input in estimating the forward-looking cost of equity using the DCF method, is fatally discrepant.

**Q. DR. VANDER WEIDE CLAIMS THAT YOUR THREE-STAGE ASSUMPTIONS  
ARE UNUSUAL AND ARBITRARY. (VANDER WEIDE REBUTTAL, P. 45).  
WHAT ARE YOUR COMMENTS?**

A. This hardly constitutes a defense of the perpetual growth assumption for companies currently experiencing high growth— an assumption that is not only arbitrary but unequivocally incorrect. As cited in my direct testimony, for example, Professor William Sharpe of Stanford and his co-authors indicated that sophisticated institutional investors found the assumptions of single-stage and two-stage models overly simplistic, and that they preferred three-stage models for providing the best combination of realism and ease of use.<sup>16</sup>

Professor Aswath Damodaran of New York University illustrates many analytical approaches for discounted cash flow modeling. Dr. Damodaran describes numerous multiple-stage DCF models with varying formulations and characteristics. Dr. Damodaran states that it is unrealistic to assume that a company with a high growth rate

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<sup>16</sup> Sharpe, William F., Gordon J. Alexander and Jeffrey V. Bailey, *Investments*, Fifth Edition, Prentice Hall, Englewood Cliffs, New Jersey, 1995, pp. 590-591.

## ***Surrebuttal Testimony of John I. Hirshleifer***

would grow at this rate in perpetuity. Depending on how high the company's current growth rate is, Dr. Damodaran suggests different patterns and different lengths of time for the high-growth period. After the period of high growth, Dr. Damodaran assumes that the company will continue to grow at the stable growth rate of economy. He suggests the following guidelines for defining the length of this first stage:<sup>17</sup>

<i>If the Current Growth Rate Is:</i>	<i>Length of High Growth Period:</i>
≤ 1 % higher than stable growth rate	No high growth
1-10 % higher than stable growth rate	5 years
> 10 % higher than stable growth rate	10 years

Notably, Dr. Damodaran *never* suggests that the single-stage DCF model should be used for companies with growth rates significantly above the growth rate of the economy.

Dr. Damodaran indicates that for companies that have super normal growth rates that are not particularly high, a two-stage or H Model could be used. Had I utilized either Dr. Damodaran's two-stage or H model with a 5-year initial stage as suggested for all of the individual telephone holding companies, the cost of equity estimates would have been lower than what I actually calculated.<sup>18</sup> Consequently, my DCF model results are conservatively high in comparison to the results of these models.

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<sup>17</sup> Damodaran, Aswath, *Applied Corporate Finance: A User's Manual*, John Wiley & Sons, 1999, p. 447.

<sup>18</sup> In Dr. Damodaran's two-stage model, the growth rate between years 5 and 20 equals the long-term growth rate. In my model, however, the growth rates are higher than the long-term rate until year 20. Consequently, the cost of equity resulting from my model will necessarily be higher than an estimate derived from Dr. Damodaran's 2-stage model.



***Surrebuttal Testimony of John I. Hirshleifer***

1    **Q.     UNDER WHAT CIRCUMSTANCES DOES DR. DAMODARAN SUGGEST**  
2        **THAT THE “H MODEL” SHOULD BE USED?**

3    A.     Dr. Damodaran states that:

4                The H model is a two-stage model for growth, but unlike the  
5                classical two-stage model, the growth rate in the initial growth phase  
6                is not constant but declines linearly over time to reach the stable-  
7                growth rate in steady stage.<sup>19</sup>

8                Dr. Damodaran indicates that the best use for this model is for firms that are growing  
9                rapidly at the present, but for which the growth is expected to decline gradually over time  
10              as their differential advantage over their competitors declines. Therefore, this model  
11              appears suitable for use with telephone holding companies.

12              As shown in Attachment JH-4 of my direct testimony, the telephone holding  
13              companies in the sample have five-year earnings growth rates between 11% and 14.8%  
14              (4.7% and 8.5% above the stable growth rate of 6.29%). Had I applied Dr. Damodaran’s  
15              H model to the set of comparables, the resulting costs of equity would have been *lower*  
16              than those that I calculated. This is because in the H model the high initial growth rates  
17              begin to decline immediately, while my DCF model assumes that the IBES five-year  
18              growth rates do not decline over the first 5 years. After the initial growth phase, the  
19              growth rate declines linearly to the long-term rate until year 20. Therefore, in every year  
20              after the first my model utilizes higher growth rates than would be used in the H model.

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<sup>19</sup> Damodaran, Aswath, *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance*, John Wiley & Sons, New York, 1994, p. 115.

*Surrebuttal Testimony of John I. Hirshleifer*

1   **Q.    WHAT DOES DR. DAMODARAN SAY ABOUT COMPANIES WHICH MIGHT**  
2       **BE APPROPRIATE FOR THE CLASSICAL TWO-STAGE DCF MODEL?**

3    A.    Damodaran suggests that one type of company for which this would be a suitable model  
4       is a company:

5               ...in an industry that is enjoying supernormal growth because  
6               significant barriers to entry (either legal or as a consequence of  
7               infrastructure requirements) can be expected to keep out new  
8               entrants for several years.

9               The assumption that the growth rate drops precipitously from its  
10              level in the initial phase to a stable rate also implies that *this model is*  
11              *more appropriate for firms with modest growth rates in the initial*  
12              *phase.* It is more reasonable, for instance, to assume that a firm  
13              growing at 12% in the high-growth period will see its growth rate  
14              drop to 6% after that than it is for a firm growing at 40% in the high-  
15              growth period.<sup>20</sup> [*emphasis added*]

16   **Q.    IF YOU ASSUMED THAT THIS WAS THE MOST APPROPRIATE MODEL TO**  
17       **USE, WHAT IMPACT WOULD IT HAVE HAD ON YOUR DCF COST OF**  
18       **EQUITY ESTIMATE?**

19   A.    As I stated above, if I had instead used this model—which certainly appears applicable in  
20       this case based on Dr. Damodaran’s analysis—it would have resulted in a *lower* cost of  
21       equity than what I actually calculated.

22   **Q.    DOES DR. DAMODARAN HIMSELF DESCRIBE A 3-STAGE DCF MODEL?**

23   A.    Yes, although his 3-stage model is more complex model and differs in many ways from  
24       the model I employ. Dr. Damodaran’s three-stage model allows for an initial period of

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<sup>20</sup> *Id.*, pp. 108-109.

## *Surrebuttal Testimony of John I. Hirshleifer*

1 high growth, a transitional period in which growth declines, and a final stable-growth  
2 phase; however, Dr. Damodaran states that his three-stage dividend discount model  
3 requires year-specific payout ratios, growth rates and betas. The purpose for year-specific  
4 betas is to compute distinct costs of equity for each phase of the model. This feature  
5 allows an analyst to refine his valuation estimate by changing the expected cost of equity  
6 in line with the analyst's estimate of the changing risk characteristics of the firm being  
7 valued. My model does not assume changing payout ratios nor does it utilize betas.  
8 Because it assumes that the cost of equity changes in each phase, Dr. Damodaran's 3-  
9 stage model cannot be used to solve for a cost of equity.

10  
11 **B. The Risks Of Supplying Unbundled Network Elements In**  
12 **Virginia Do Not Justify The Use Of DCF Comparison Groups**  
13 **That Include Non-Telephone Companies.**

14 **1. TELRIC cost principles do not require the Commission to**  
15 **assume that Verizon Virginia faces intense competition**  
16 **regardless of the facts.**

17 **Q. DR. VANDER WEIDE CLAIMS THAT YOUR COST OF CAPITAL ESTIMATE**  
18 **IS INCONSISTENT WITH THE FORWARD-LOOKING ECONOMIC COST**  
19 **PRINCIPLES ESTABLISHED BY THE FCC (VANDER WEIDE REBUTTAL, P.**  
20 **2). IS THIS CORRECT?**

21 **A.** No. Dr. Vander Weide overlooks numerous key provisions of the FCC August 8, 1996  
22 Order which provide guidance for the determination of costs of capital associated with  
23 UNEs.

24 Dr. Vander Weide states that:

## *Surrebuttal Testimony of John I. Hirshleifer*

1 [T]he forward-looking economic cost principle is economically  
2 relevant only in a competitive market for telecommunications  
3 services. Thus, the forward-looking economic cost principle, at its  
4 heart, is based on the assumption that the market for local exchange  
5 services is fully competitive. [Vander Weide direct testimony p. 36]

6 A proper definition of the cost of capital for use in Verizon MA's  
7 forward-looking cost studies is based on the assumption that the  
8 market for local exchange services is competitive. [Vander Weide  
9 direct testimony p. 46]

10 [T]his commission's cost study principles require that cost studies  
11 "replicate...the conditions of a competitive market" for unbundled  
12 network elements. [Vander Weide direct testimony p. 42]

13 Mr. Hirshleifer's cost of capital estimate is intended to be used as an  
14 input to AT&T/WorldCom's forward-looking economic cost studies,  
15 which, according to the Commission, should produce rates that  
16 replicate the results of a competitive telecommunications market.  
17 [Vander Weide rebuttal testimony p. 6]

18 Dr. Vander Weide also argues in this testimony (Vander Weide rebuttal p. 6) that the  
19 FCC required the assumption of a competitive telecommunications market. This  
20 assumption is contrary to the purpose of the 1996 Act and ¶¶ 688 and 702 of the FCC  
21 August 8, 1996 Order. In particular, paragraph 702 of the FCC's *Local Competition*  
22 *Order* of August 8, 1996 makes explicit statements that entirely disprove Dr. Vander  
23 Weide's interpretation. I highlighted those statements at page 4 of my rebuttal testimony.  
24 In contrast, the cost of capital that I have recommended is a risk-adjusted cost of capital  
25 referenced in ¶ 702, and takes into account all relevant risks.

26 The FCC August 8, 1996 Order is replete with statements in other sections that  
27 further contradict Dr. Vander Weide's erroneous assumptions.

28 For example,

## *Surrebuttal Testimony of John I. Hirshleifer*

1 The 1996 Act *encourages* competition by removing barriers to entry  
2 and providing an opportunity for potential new entrants to purchase  
3 unbundled incumbent LEC network elements to compete efficiently  
4 to provide local exchange services. [¶ 672] *[emphasis added]*

5 *The incumbent LEC offerings to be priced using this methodology*  
6 *generally will be "network elements," rather than*  
7 *"telecommunications services," as defined by the 1996 Act. More*  
8 *fundamentally, we believe that TELRIC-based pricing of discrete*  
9 *network elements or facilities, such as local loops and switching, is*  
10 *likely to be much more economically rational than TSLRIC-based*  
11 *pricing of conventional services, such as interstate access service*  
12 *and local residential or business exchange service. [¶ 678]*  
13 *[emphasis added]*

14 Congress recognized in the 1996 Act that *access to the incumbent*  
15 *LEC's bottleneck facilities is critical to making meaningful*  
16 *competition possible. As a result of the availability to competitors of*  
17 *the incumbent LEC's unbundled elements at their economic cost,*  
18 *consumers will be able to reap the benefits of the incumbent LEC's*  
19 *economies of scale and scope, as well as the benefits of competition.*  
20 *Because a pricing methodology based on forward-looking costs*  
21 *simulates the conditions in a competitive marketplace, it allows the*  
22 *requesting carrier to produce efficiently and to compete effectively,*  
23 *which should drive retail prices to their competitive levels. We*  
24 *believe that our adoption of a forward-looking cost-based pricing*  
25 *methodology should facilitate competition on a reasonable and*  
26 *efficient basis by all firms in the industry by establishing prices for*  
27 *interconnection and unbundled elements based on costs similar to*  
28 *those incurred by the incumbents, ...[¶ 679] [emphasis added]*

29 ...we find that *incumbent LECs must prove* to the state commission  
30 the nature and magnitude of any forward-looking cost that it seeks to  
31 recover in the prices of interconnection and unbundled network  
32 elements. [¶ 680]

33 It is evident from a reading of the FCC August 8, 1996 Order that the FCC does  
34 not accept Dr. Vander Weide's argument that cost should be based on  
35 telecommunications services, nor that there should be a hypothetical assumption that the

***Surrebuttal Testimony of John I. Hirshleifer***

1 risks of a fully competitive market exist for UNEs when in fact they do not. While Dr.  
2 Vander Weide asserts in this proceeding that actual UNE competition justifies an  
3 assumption of a fully competitive market, he has not met his burden of proof in this  
4 regard. Dr. Vander Weide's failure to provide convincing evidence means that his  
5 already-questionable selection of the S&P Industrials as the basis for his cost of capital  
6 calculation is not supportable.

7 **Q. HAS ANY COURT AGREED WITH YOU ABOUT THE RISK ASSUMPTIONS**  
8 **IMPLIED BY THE TELRIC STANDARD?**

9 A. Yes. In the 1997 UNE proceeding before the Delaware PSC, Dr. Vander Weide argued  
10 for Bell Atlantic, as he now does in the FCC Virginia proceeding, that the TELRIC  
11 standard requires state commissions to assume that the supplier of unbundled network  
12 elements faces intense competition. The Delaware Public Service Commission rejected  
13 this argument for the same reasons I offer here. Bell Atlantic appealed to the United  
14 States District Court in Delaware. The court upheld the Delaware Commission on this  
15 point, again for the same reasons I have offered here:

16 Bell points to an apparent contradiction in assuming instantly  
17 competitive prices for network elements (even though no such  
18 competition now exists) but, in the context of determining cost of  
19 capital, assuming little competition and, consequently, low costs of  
20 capital. ... The Telecommunications Act attempts to recreate the  
21 prices that a hypothetical efficient company would charge for its  
22 network elements and services in a competitive market. Indulging in  
23 this fiction, however, does not change the fact that ILECs like Bell  
24 do not face the same competitive risks as firms operating in a  
25 competitive market. Indeed, ILECs have had no competition for  
26 decades, and they will face little competition in the market for  
27 network elements in the near future. *See August 8, 1996 Order ¶*  
28 *702, at 353.* Therefore, in introducing competition in the local

***Surrebuttal Testimony of John I. Hirshleifer***

1 telephone market, it makes perfect sense to recreate competitive  
2 prices while acknowledging that the current lack of competition  
3 warrants reduced costs of capital.<sup>21</sup>

4 **Q. HAS ANY OTHER ECONOMIC CONSULTANT TO VERIZON AGREED WITH**  
5 **THE U.S. DISTRICT COURT ON THIS POINT?**

6 A. Yes. National Economic Research Associates (“NERA”) is a consultant to Verizon. Dr.  
7 William Taylor, Verizon’s economic witness in multiple TELRIC proceedings, is a senior  
8 vice president with NERA. In the UNE cost proceeding before the New York Public  
9 Service Commission last year, an excerpt of a report authored by NERA was entered as  
10 evidence. That excerpt states in part:

11 In terms of the more general concept of incremental costs, TELRIC  
12 maintains the following specific assumptions.

13 First, the business decision being modeled is that of a hypothetical  
14 local exchange carrier that offers unbundled elements to retail  
15 providers (possibly itself) at undifferentiated prices. Hence the  
16 increments in question are the total volume for the elements  
17 demanded by the retail providers.

18 Second, the time horizon over which the ILEC offers the wholesale  
19 elements is assumed to be the longest of the long-run. *Implicit in*  
20 *this definition are the assumptions that (1) the ILEC will effectively*  
21 *be a monopolist in the provision of network elements for the*  
22 *indefinite future and (2) competitors will need to obtain such*  
23 *elements to compete over this time frame.*<sup>22</sup> [footnotes omitted;  
24 *emphasis added*]

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<sup>21</sup> *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d 218 (D. Del. 2000) at 240 n. 19.

<sup>22</sup> Excerpt from “An Economic Evaluation of Network Cost Models”, NERA, August 7, 2000, Exhibit 408, State of New York Public Service Commission, *Proceeding on Motion of the Commission to Examine New York Telephone Company’s Rates for Unbundled Network Elements*, Case 98-C-1357.

## *Surrebuttal Testimony of John I. Hirshleifer*

1 Dr. Taylor has himself acknowledged the distinction between attempting to  
2 replicate the *costs* of a firm in a competitive market, and arbitrarily assuming that an  
3 incumbent monopoly carrier faces the *risks* of a firm in a competitive market. Testifying  
4 in the UNE proceeding in Virginia in 1997, Dr. Taylor agreed that it was not unheard of  
5 for regulators to set prices in noncompetitive markets that replicate the prices that would  
6 result from a competitive market.<sup>23</sup> Moreover, he conceded that it was possible for a  
7 regulatory standard which sets rates at competitive levels to coexist with an environment  
8 in which the regulated firm faces less competitive risks than a competitive firm would  
9 face.<sup>24</sup>

10 **Q. BOTH DR. VANDER WEIDE AND DR. SHELANSKI CITE A FOOTNOTE TO**  
11 **THE FCC’S BRIEF TO THE SUPREME COURT WHICH STATES THAT “AN**  
12 **APPROPRIATE COST OF CAPITAL DETERMINATION TAKES INTO**  
13 **ACCOUNT NOT ONLY EXISTING COMPETITIVE RISKS...BUT ALSO RISKS**  
14 **ASSOCIATED WITH THE REGULATORY REGIME TO WHICH A FIRM IS**  
15 **SUBJECT.” (VANDER WEIDE REBUTTAL, P. 19; SHELANSKI REBUTTAL, P.**  
16 **10) IS THIS STATEMENT SUPPORTIVE OF YOUR APPROACH, OR OF DR.**  
17 **VANDER WEIDE’S?**

18 A. It is helpful to mine. The quoted language makes clear that the cost of capital used in  
19 determining UNE prices must take account of the particular competitive risks, existing

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<sup>23</sup> *Ex Parte to Determine Prices Bell Atlantic—Virginia, Inc. Is Authorized to Charge Competing Local Exchange Carriers in Accordance with the Telecommunications Act of 1996 and Applicable State Law*, Virginia State Corporation Commission, Case No. PUC970005, Tr. at 580 (statement of William E. Taylor).

<sup>24</sup> *Id.* at 581 (emphasis added).



## ***Surrebuttal Testimony of John I. Hirshleifer***

1 and anticipated by the market, entailed in supplying UNEs, as well as regulatory risks  
2 anticipated by the market. By necessary implication, the analyst may not simply assume,  
3 without analysis, that the relevant risks are those of a vigorously competitive market. My  
4 cost of capital analysis considers both the competitive and regulatory risks that would  
5 face a wholesale supplier of UNEs in Virginia. Dr. Shelanski's statement that "the  
6 modified Synthesis Model contains no provision for such risk" [Shelanski Rebuttal, p.  
7 10] is therefore incorrect. In contrast, Dr. Vander Weide's use of an incorrect comparison  
8 group based on S&P Industrial companies considers neither set of risks.

9 **Q. IS DR. VANDER WEIDE'S POSITION REGARDING AN ASSUMPTION OF**  
10 **COMPETITIVE RISKS CONSISTENT WITH VERIZON'S OWN POSITION?**

11 A. No. In its brief to the Supreme Court supporting its opposition to the use of TELRIC,  
12 Verizon stated that:

13 ...TELRIC similarly presumes that carriers in its fictional world of  
14 constant network replacement would nonetheless continue to have  
15 the same cost of capital established for incumbents in the stable,  
16 low-risk monopoly system of the past...

17 The FCC's order, moreover, requires the States to start with the  
18 existing rate of return, and places the burden on incumbents to  
19 demonstrate with specificity that the business risks—defined  
20 exclusively in terms of facilities-based entry by competitors—justify  
21 any change in the rate of return.<sup>25</sup>

22 Verizon cites ¶¶ 687, 688 and 702 of the FCC's August 8, 1996 Order in support of these  
23 statements.

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<sup>25</sup> *Brief for Petitioners*, On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit, In the Supreme Court of the United States, October Term, 2000, No. 00-511.

*Surrebuttal Testimony of John I. Hirshleifer*

1                   **2. Dr. Vander Weide exaggerates the competitive risk of VZ-**  
2                   **VA's local telephone service generally and fails to**  
3                   **distinguish between the competitive risks of providing UNEs**  
4                   **at wholesale and providing local telephone services at retail.**

5   **Q. HAS ANY COURT NOTED DR. VANDER WEIDE'S FAILURE TO**  
6                   **DISTINGUISH BETWEEN THE COMPETITIVE RISKS OF PROVIDING UNES**  
7                   **AT WHOLESALE AND PROVIDING LOCAL TELEPHONE SERVICES AT**  
8                   **RETAIL?**

9   **A.** Yes. In *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d 218, 240 (D.Del. 2000),  
10 the court stated as follows (emphasis in original):

11                   In assessing Bell's case for an elevated cost of equity, the Hearing  
12                   Examiners criticized the testimony of Bell's expert, Dr. James Vander  
13                   Weide. The Examiners noted that Vander Weide based his cost of equity  
14                   on the risk associated with Bell's retail business instead of on the future  
15                   demand for Bell's network elements that it will sell at *wholesale*. AT&T's  
16                   expert, Bradford Cornell, also criticized Vander Weide's analysis as  
17                   "ignor[ing] the critical fact that the business at hand in this proceeding is  
18                   *not* local retail phone service that already exists, but rather the new  
19                   business of leasing of network elements at *wholesale* for use in providing  
20                   competitive phone services to an existing *retail* market." [citation  
21                   omitted] The distinction between wholesale and retail is crucial.

22                   Retail competition is competition for the end user of telephone service.  
23                   That sort of competition is not at issue when determining the risks  
24                   associated with leasing unbundled network elements (e.g., loops and  
25                   switches) at wholesale. The risks associated with leasing "bottleneck"  
26                   network elements at wholesale is less than that associated with  
27                   competition for retail service. *See August 8, 1996 Order* ¶ 702, at 353  
28                   (noting that network elements "generally are bottleneck, monopoly  
29                   services that do not now face significant competition"). This is so because  
30                   Bell often is the only provider of these network elements, and it is to Bell  
31                   that new entrants must come to lease or purchase loops, switches, or other  
32                   network elements. Thus, even if retail competition intensifies, Bell's  
33                   prominence as a wholesale provider of network elements will remain  
34                   largely unaffected—at least until new entrants build their own networks.

## ***Surrebuttal Testimony of John I. Hirshleifer***

1 [footnote omitted] Accordingly, the Hearing Examiners correctly rejected  
2 Vander Weide's testimony as impermissibly attributing the risks of retail  
3 competition to the competition in the sale of unbundled network elements.  
4 *See August 8, 1996 Order* ¶ 691, at 348 (explaining that, "[o]nly those  
5 costs that are incurred in the provision of network elements in the long run  
6 shall be directly attributable to those elements").

7 **Q. IN HIS REBUTTAL TESTIMONY DR. VANDER WEIDE HAS ARGUED THAT**  
8 **"SIGNIFICANT FACILITIES-BASED COMPETITION ALREADY EXISTS FOR**  
9 **LOCAL EXCHANGE SERVICES IN VIRGINIA, AND INVESTORS EXPECT**  
10 **FUTURE COMPETITION TO INCREASE RAPIDLY." (VANDER WEIDE**  
11 **REBUTTAL, P. 21) WHAT IS YOUR RESPONSE TO THIS ARGUMENT?**

12 A. I have reviewed the evidence that Dr. Vander Weide suggests for competition in Virginia.  
13 In general, his examples do not clearly distinguish between facilities offered by network  
14 competitors, and end users which are retail customers of competitors but ultimately use  
15 VZ-VA's network elements. He thus ignores the crucial distinction recognized by the  
16 U.S. District Court in Delaware. As stated by ABN Amro in its January 20, 2000 report  
17 covering Bell Atlantic, for example, 1.1 million access lines that Bell Atlantic supposedly  
18 lost to competition as of the close of the third quarter of 1999 are *were in fact being*  
19 *supplied by Bell Atlantic on a wholesale basis.*<sup>26</sup> In its August 2000 announcement of  
20 quarterly results, Verizon stated that its "wholesale business provid[es] nearly 2.9 million  
21 switched access lines and 541,000 unbundled loops."<sup>27</sup> To the extent that competitors are  
22 using Verizon's network elements, Bell Atlantic retains those facilities revenues and has

<sup>26</sup> ABN Amro also added that "[o]ffsetting these setbacks, Bell Atlantic added nearly 6 million lines from year-end 1995 through the third quarter of 1999, a 3.2% CAGR." (p. 24) [emphasis added]

<sup>27</sup> Verizon Press Release, "Verizon Communications Announces Second Quarter Results," August 8, 2000.

***Surrebuttal Testimony of John I. Hirshleifer***

1 lost nothing on the UNE level, which is the sole subject of this proceeding.<sup>28</sup> Without  
2 evidence that the network facilities business, as opposed to the local exchange or  
3 telecommunications businesses, has become dramatically competitive, Verizon has failed  
4 to satisfy at least one element of its burden of proof required by paragraphs 680 and 702  
5 of the FCC August 8, 1996 Order.

6 **Q. DR. VANDER WEIDE ARGUES THAT THE MINIMAL CLEC PENETRATION**  
7 **NOTED IN DIRECT TESTIMONY OF MR. WEST PORTENDS GREAT UNE**  
8 **COMPETITION IN THE FUTURE. (VANDER WEIDE REBUTTAL, P. 22)**  
9 **HOW DO YOU RESPOND TO THIS ARGUMENT?**

10 A. Dr. Vander Weide's predictions about future competitive developments are empty  
11 speculation; they ignore the high barriers to entry that appear likely to remain in the  
12 foreseeable future. The recent bankruptcies of one-time potential competitors such as  
13 Northpoint, Rhythms and Covad merely underscore the fanciful nature of Dr. Vander  
14 Weide's projections of competition.

15 Even on the level of retail local exchange, Verizon is experiencing a decline in  
16 competitive entry:

17 Verizon is seeing a significant slowdown in the sequential growth in  
18 its reported wholesale lines as CLECs are hit by the drop off in  
19 funding. In Q2 00 533,000 wholesale lines were added, in Q3 00  
20 364,000 lines were added, in Q4 00 335,000 lines were added, and in  
21 Q1 01 only 84,000 wholesale lines were added. If this trend  
22 continues, we could see far less share loss to competitors that we  
23 currently have factored in to our projections. With most CLECs in

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<sup>28</sup> In its May 15, 2000 "Telecom - Wireline" report Morgan Stanley Dean Witter highlighted that in the first quarter of 2000 it "saw some renewed strength in local and access revenues. Sales of value added services and strong wholesale business more than offset local competition."

*Surrebuttal Testimony of John I. Hirshleifer*

1           dire financial straits right now, any upside on the competitive front  
2           could be a powerful offset to any potential lingering economic  
3           weakness.<sup>29</sup>

4   **Q.    IS IT NOT POSSIBLE THAT FACILITIES-BASED COMPETITION,**  
5       **WHETHER EXISTING TODAY OR EMERGING IN THE DISTANT FUTURE,**  
6       **WOULD DEPRIVE VZ-VA OF REVENUES IN THE BUSINESS OF LEASING**  
7       **UNBUNDLED NETWORK ELEMENTS?**

8   **A.**   Given enough time, anything is possible. The market has already incorporated its  
9       expectations of any such losses, however, in the price of Verizon's stock. If such fears of  
10      competition were significant to investors' estimates of the required cost of capital, they  
11      have already accounted for them in valuing Verizon's stock.

12           Morgan Stanley states that,

13           There is no doubt that competitive pressures are significant in the  
14           industry, with the recent opening up of New York to Bell Atlantic  
15           long distance heralding the new era. Nevertheless, we continue to  
16           firmly believe that the pie is growing, and those companies who  
17           execute effectively can succeed despite competitive pressures. The  
18           Bells have already absorbed significant local and toll competition  
19           from CLECs as well as significant rate reductions over the past  
20           several years. We also see the control of the customer, and the local  
21           loop combining with scale advantages to create significant  
22           competitive leverage for the local phone companies.<sup>30</sup>

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<sup>29</sup>   Dresdner, Kleinwort, Wasserstein Research, "Verizon Communications", June 29, 2001, p. 2.

<sup>30</sup>   Morgan Stanley Dean Witter, "Telecom - Wireline", January 21, 2000.

*Surrebuttal Testimony of John I. Hirshleifer*

1   **Q.     FROM THE STANDPOINT OF FINANCE THEORY, IS COMPETITIVE RISK**  
2       **GENERALLY ACCEPTED AS BEING RELEVANT TO THE**  
3       **DETERMINATION OF THE COST OF CAPITAL?**

4   **A.**    As I discussed in my direct testimony, capital market theory indicates that the market  
5       would not increase the cost of capital for competitive risks which investors can diversify  
6       away by purchasing a diversified portfolio of stocks.

7   **Q.     IN HIS REBUTTAL TESTIMONY DR. VANDER WEIDE HAS TESTIFIED**  
8       **THAT TELEPHONE HOLDING COMPANIES ARE ACTUALLY LESS RISKY**  
9       **THAN THE LEC'S BECAUSE THEY HAVE DIVERSIFIED (VANDER WEIDE**  
10      **REBUTTAL, P. 31).<sup>31</sup> CAN THIS BE TRUE?**

11   **A.**    No. As I stated in my rebuttal testimony, engaging in businesses which are  
12       systematically riskier than the wholesale network element business, such as wireless or  
13       international ventures, will always make the risk of the telephone holding company  
14       greater than that of the wholesale network element business. Overall risk can never fall  
15       because of the acquisition of systematically riskier businesses.

16           In its last access charge rate represcription proceeding, the FCC stated that:

17               It seems counterintuitive to suggest, as Bell Atlantic does, that  
18               diversification into riskier businesses could actually reduce the  
19               business risk of an RHC so that it is lower than the business risk of  
20               the regulated business.<sup>32</sup>

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<sup>31</sup> Dr. Hausman has similarly argued at pages 19 to 21 of his rebuttal testimony that the UNE business is riskier than the overall risk of Verizon.

<sup>32</sup> FCC Order 90-315, In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, September 19, 1990, ¶ 84, p. 7517.

*Surrebuttal Testimony of John I. Hirshleifer*

1                   However, the record does show that the RHCs are also involved in  
2                   activities which are perceived as riskier than their regulated  
3                   telephone business. We therefore find that we should give some  
4                   weight in our decision to the possibility that a cost of equity estimate  
5                   for an RHC as a whole company might somewhat *overstate* the cost  
6                   of equity for interstate access service alone. [*emphasis added*] (*Id.*, ¶  
7                   86, p. 7517).

8                   **3.     Dr. Vander Weide has not offered plausible or consistent**  
9                   **reasons why telephone companies should not form the**  
10                  **appropriate DCF comparison group.**

11    **Q.     WHAT REASON DOES DR. VANDER WEIDE GIVE FOR USING AN S&P**  
12           **INDUSTRIAL COMPARABLE SET?**

13    A.     He states that:

14                   Since the S&P Industrials are a group of competitive firms whose  
15                   composite risk is average, I have selected them as a reasonable proxy  
16                   for Verizon VA's risk of providing unbundled network elements in a  
17                   competitive market. [Vander Weide rebuttal, p. 39]

18           Notably, Dr. Vander Weide again offers no proof for this assertion.

19    **Q.     YOU PREVIOUSLY CITED DR. VANDER WEIDE'S BELIEF THAT THE UNE**  
20           **MARKET IS ALREADY COMPETITIVE (VANDER WEIDE, P. 21). IF SO,**  
21           **COULD HE HAVE JUST USED A SAMPLE OF TELEPHONE HOLDING**  
22           **COMPANIES?**

23    A.     Of course.

24    **Q.     WHAT ARGUMENTS DOES DR. VANDER WEIDE CURRENTLY OFFER FOR**  
25           **NOT USING THE CLOSEST COMPARABLE COMPANIES?**

26    A.     Dr. Vander Weide's reasons are as follows:

***Surrebuttal Testimony of John I. Hirshleifer***

1           The DCF and CAPM Models provide more uncertain estimates of  
2           the cost of equity for companies such as the holding companies that  
3           are experiencing radical restructuring and profound regulatory,  
4           organizational and technological change. In addition, the four or five  
5           THCs are simply too small a group to obtain reliable cost of equity  
6           estimates. [Vander Weide rebuttal, pp. 37-38]

7   **Q.    WAS DR. VANDER WEIDE OFFERING A DIFFERENT ARGUMENT IN THE**  
8   **RECENT NEW YORK UNE COST PROCEEDING?**

9   A.    Yes. In his New York UNE cost proceeding rebuttal testimony, Dr. Vander Weide  
10       argued that telephone holding companies either involved in mergers or subject to merger  
11       speculation could not be used as proxies for other telephone holding companies because  
12       “the projected earnings growth associated with the mergers is not reflected in the  
13       analysts’ growth rates” used in DCF analyses. (Vander Weide New York responsive  
14       testimony, p. 30) he assumed that the stock prices would immediately rise upon the  
15       merger news and concluded that the DCF cost of equity would be biased downward. In  
16       support of his claim, Dr. Vander Weide produced in his New York responsive testimony  
17       an exhibit showing gradually rising I/B/E/S forecast growth rates for several merging  
18       telecommunications companies.

19           I showed that these data did not support Dr. Vander Weide’s claim. First, Dr.  
20       Vander Weide assumed that the increase of I/B/E/S forecast growth rates over the last  
21       several years result solely from mergers. However, each of the companies selected by Dr.  
22       Vander Weide has engaged in numerous high-growth endeavors during the period  
23       illustrated in his exhibit. Obviously, a far greater proportion of growth rate increases  
24       would derive from high-growth businesses than would arise from the cost cutting  
25       measures which mergers make possible. Industry analysts have stated that “data and



## *Surrebuttal Testimony of John I. Hirshleifer*

1 wireless continue to expand [LECs'] piece of the revenue pie."<sup>33</sup> ABN AMRO reiterated  
2 that it saw "three catalysts of Bell Atlantic growth: high-speed data, global wireless and  
3 long-distance entry."<sup>34</sup> Verizon's international business segment, as an example, grew by  
4 18.6% in 2000 and 21.2% in 1999.<sup>35</sup>

5 Second, had Dr. Vander Weide investigated these mergers, he would have found  
6 that the stock price of at least one of the companies declined after the announcement of  
7 the merger.<sup>36</sup> A decline in the stock price would result in a *higher* cost of equity if DCF  
8 model calculations were performed keeping all other parameters unchanged. Moreover,  
9 after the merger was announced the aggregate market capitalization of the two merging  
10 companies went down in 5 out of 6 cases.

11 Another example in the news was the failed WorldCom/Sprint merger. When  
12 U.S. antitrust officials announced their intentions to investigate the planned merger,  
13 Sprint's stock price *rose* by 8.7% instead of declining. The day the Department of Justice  
14 filed suit to block the merger, WorldCom's stock price *increased* by 12.28%, while  
15 Sprint's stock price decreased by 9.56%. Contrary to Dr. Vander Weide's assertions, in  
16 the instances where a company's stock price is depressed because of merger anticipation,  
17 such as MCI WorldCom's stock, a DCF calculation would have provided a *higher*, not  
18 lower cost of equity estimate.

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<sup>33</sup> Morgan Stanley Dean Witter, "Telecom - Wireline", May 15, 2000.

<sup>34</sup> ABN AMRO, "Bell Atlantic Corporation", January 20, 2000.

<sup>35</sup> Verizon Communications Inc. SEC Form 10-K405 for the period ending 12/31/00.

<sup>36</sup> SBC stock declined after the announcement of each of its three mergers: SBC/Pacific Telesis, SBC/SNET and SBC/Ameritech. In three other mergers mentioned by Dr. Vander Weide, all stocks declined after the announcements except for Bell Atlantic stock's in connection with its merger with NYNEX.

*Surrebuttal Testimony of John I. Hirshleifer*

1   **Q.   HAS DR. VANDER WEIDE ATTEMPTED TO DETERMINE WHICH**  
2       **COMPANIES IN HIS S&P INDUSTRIAL SAMPLE ARE SUBJECT TO**  
3       **MERGER OR ACQUISITION SPECULATION IN THIS PROCEEDING?**

4   A.   No. And it is very ironic that Dr. Vander Weide does not cull out telephone holding  
5       companies that he suggested would yield downwardly-biased cost of equity estimates in  
6       the New York UNE cost proceeding. While Dr. Vander Weide has argued that mergers  
7       and merger speculation are important to the selection of appropriate comparables, he has  
8       not analyzed the companies in his sample to determine which ones are in industries that  
9       have or are anticipating merger activity. Standard & Poor's itself acknowledges that  
10      "[t]he S&P 500 is a great list of merger candidates—the companies are well known and  
11      widely followed on Wall Street. The list is one of the first places an investment banker  
12      turns when searching for a big target."<sup>37</sup>

13           Other examples of industries represented in the S&P Industrials that have been  
14      involved in substantial merger activity are the banking industry (Wells Fargo, Chase  
15      Manhattan and US Bancorp merged with various smaller banks); the chemical industry  
16      (Eastman Chemical, Great Lakes Chemical have been involved in mergers); the food and  
17      beverages industry (Bestfoods, ConAgra, General Mills, HJ Heinz, Seagram, Kellogg  
18      participated in mergers); the entertainment industry (Time Warner merger with AOL,  
19      CBS with Viacom); the newspaper industry (Times Mirror merged with Tribune), etc.

20   **Q.   HAS DR. VANDER WEIDE ATTEMPTED TO DETERMINE AND CULL OUT**  
21       **COMPANIES IN HIS S&P INDUSTRIAL SAMPLE THAT ARE SUBJECT TO**

<sup>37</sup>

[www.spglobal.com/howmany.html](http://www.spglobal.com/howmany.html).

*Surrebuttal Testimony of John I. Hirshleifer*

1        **RESTRUCTURING, OR TO REGULATORY, ORGANIZATIONAL OR**  
2        **TECHNOLOGICAL CHANGE WHICH IN HIS VIEW WOULD MAKE DCF**  
3        **COST OF EQUITY ESTIMATES MORE UNCERTAIN?**

4        A.     No, he has not.

5        **Q.     IN YOUR EXPERIENCE, HAS DR. VANDER WEIDE EVER**  
6        **ACKNOWLEDGED THAT TELEPHONE HOLDING COMPANIES ARE**  
7        **APPROPRIATE COMPARABLES FOR OTHER TELEPHONE HOLDING**  
8        **COMPANIES?**

9        A.     Not that I can recall. For example, Dr. Vander Weide proposed the use of the S&P 500 to  
10        verify the reasonableness of the USTA cost of equity estimate in the FCC's access charge  
11        rate represcription proceeding completed in 1990, well before the 1996 Act.<sup>38</sup> The FCC  
12        properly rejected the use of Dr. Vander Weide's index approach in the 1990 proceeding.<sup>39</sup>  
13        Dr. Vander Weide's longstanding advocacy of S&P Index companies as a DCF proxy  
14        group for local telephone companies clearly predates the recent regulatory and  
15        competitive developments that ostensibly justify his approach.

16       **Q.     DR. VANDER WEIDE OBJECTS TO YOUR USE OF A SAMPLE THAT ONLY**  
17       **INCLUDES FIVE TELEPHONE COMPANIES. (VANDER WEIDE REBUTTAL,**

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<sup>38</sup> "Bell Atlantic asserts that because the S&P 500 is a group of large industrial firms, it is an excellent benchmark for determining the interstate access cost of equity and can be used to verify the reasonableness of the results of the USTA cluster analysis. USTA argues that the S&P 400 is a proxy for the competitive marketplace." FCC Order 90-315, In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, September 19, 1990, ¶144, p. 7524.

<sup>39</sup> *Id.* at ¶162, P. 7526.

## *Surrebuttal Testimony of John I. Hirshleifer*

1        **PP. 37-38) IS IT PREFERABLE TO USE A LARGER SAMPLE OF**  
2        **NONCOMPARABLE COMPANIES AS HE ADVOCATES?**

3        A.        Obviously not. The purpose for using a larger sample, when there are enough  
4        comparable companies that can be included in that sample, is to reduce measurement  
5        error in order to arrive at averages that more closely represent the true mean for the  
6        comparable company group. Even if one's sample by necessity is small, however, the  
7        averaging process reduces measurement error. In contrast, averaging over a group of  
8        noncomparable companies yields a mean *that in no way measures the parameter one is*  
9        *attempting to estimate for the subject company or for its industry.*

10        As Myers and Borucki put it:

11                In real life, errors in estimating investors' forecasts of future growth  
12                are inevitable. The errors will occur even if all the DCF method's  
13                assumptions are satisfied. This does not invalidate the method; all  
14                approaches to measuring the cost of equity are liable to random  
15                error. *Responsible analysts attempt to average across similar*  
16                *companies whenever possible.*<sup>40</sup>

17        According to Dr. Vander Weide's flawed reasoning, it would be preferable to use  
18        a large sample of unrelated stocks trading on the Paris Bourse over a smaller sample of  
19        comparable telephone holding companies.

20        **Q.        DOES DR. VANDER WEIDE FOLLOW THIS RULE OF NOT USING SMALL**  
21        **SAMPLES OF COMPARABLE COMPANY GROUPS?**

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<sup>40</sup> Stewart C. Myers and Lynda S. Borucki, "Discounted Cash Flow Estimates of the Cost of Equity Capital—A Case Study", *Financial Markets, Institutions & Instruments*, vol. 3, no. 3, New York University Salomon Center, 1994, p. 17. [*emphasis added*].

### ***Surrebuttal Testimony of John I. Hirshleifer***

1     A.     No. For example, in his New York responsive testimony, Dr. Vander Weide presented  
2           alleged “tests of reasonableness” similar to those that he presents in his rebuttal testimony  
3           for this proceeding. He calculated DCF results for groups of companies that he described  
4           as “interexchange carriers” and “large industrials.” For the “interexchange carrier” group  
5           he averaged over a sample *of only two companies*. For his “large industrial” group, he  
6           averaged over a sample *of just three companies*. In both instances, he could have  
7           included more companies that fell within those groups, but consciously chose not to do  
8           so. In the case of “large industrials”, his own S&P Industrial sample group would have  
9           allowed him to use a sample group of substantial size. In the present case he averages  
10          over only three companies for his group of “natural gas distribution companies”, and  
11          averages over a group of only four “telecommunications companies”, with Verizon itself  
12          notably excluded from the sample.

13           **C.     The S&P Industrial Companies Selected By Dr. Vander Weide**  
14           **Are Not A Valid Comparison Group For A DCF Analysis Of The**  
15           **Cost Of Equity Of The Network Element Business.**

16     Q.     **DR. VANDER WEIDE ALLEGES THAT THE GROUP OF S&P INDUSTRIALS**  
17           **PROVIDES “A REASONABLE PROXY FOR VERIZON VA’S RISK OF**  
18           **PROVIDING UNBUNDLED NETWORK ELEMENTS IN A COMPETITIVE**  
19           **MARKET.” (VANDER WEIDE REBUTTAL, P. 39) HAS ANY COURT**  
20           **EVALUATED THE LEGITIMACY OF DR. VANDER WEIDE’S USE OF S&P**  
21           **INDUSTRIAL COMPANIES AS COMPARABLES FOR TELEPHONE**  
22           **COMPANIES?**